המוסד הישראלי לתקינה בחשבונאות
Israel Accounting Standards Board

October 22st, 2010

International Accounting Standards Board
30 Cannon Street, London EC4M 6XH
United Kingdom

Dear Madam or Sir,

Exposure Draft ED/2010/6 - Revenue from Contracts with Customers

The Israel Accounting Standards Board is pleased to have this opportunity to comment on the IASB's Exposure Draft ED/2010/6 *Revenue from Contracts with Customers* published in June 2010.

General comments

The proposed Standard was intended to reduce the existing complexity and to replace the risks and rewards approach with the control approach. While we do believe that the proposed Standard achieved the goal of providing guidance for implementing the control approach, we are deeply concerned with the implications of this approach on accounting for certain long-term contracts and, under certain fact patterns, we believe that these implications might even impair the relevancy of the information reported. The proposed principle of "control" set forth in the ED might prove inappropriate for certain long-term construction contracts for which control is not transferred continuously. We believe that the economic results and impacts of such long-term contracts on the entity's financial statements would best be reflected as progress towards completion is carried out - i.e., underlying efforts and inputs invested by the entity are best reflected as the performance obligation is being progressively fulfilled. We have further observed that application of the proposed principles results in delayed revenue recognition for such contracts causing the reported results within an entity's financial statements to be outdated and, thus, to certain extent, not relevant. In addition, the entity will present during construction periods losses resulting from on-going contract costs not eligible for capitalization under paragraphs 57 through 63 (i.e., general and administrative costs) and present in the period of the completion of the project and delivery to the customer the overall profit from the contract. The above mentioned is relevant both to construction contracts that are in the scope of IAS 11 and those in the scope of IAS 18 (i.e., services). Currently, prior to these proposals which encompasses the elimination of IAS 11, construction contract in the scope of IAS 11 was accounted for using the percentage of completion method and thus its results were reported in accordance with the stage of completion.

On the same basis, we believe that the application of the proposed principles to long-term services, which is satisfied by the submission of a final report, where there is no interim reports or sharing of findings required as well as no ability of the customer to change the specifications of the service, will result in treating these services as the sale of goods rather than services (resulting in the deferral of revenue till the final report is submitted to the customer).

Please find below our detailed comments:

Question 1

Paragraphs 12-19 propose a principle (price interdependence) to help an entity determine whether:

- **(a) to combine two or more contracts and account for them as a single contract;**
- **(b) to segment a single contract and account for it as two or more contracts;**
- **(c) to account for a contract modification as a separate contract or as part of the original contract.**

Do you agree with the principle? If not, what principle would you recommend, and why, for determining whether (a) to combine or segment contracts and (b) to account for a contract modification as a separate contract?

We agree with the proposed principle of price interdependence. However, the application of the principle for the determination if a contract modification should be accounted for as a single contract or as part of the original contract is unclear. We believe the Board should add guidance on the meaning of interdependence in a contract modification since the indicators provided in paragraph 13 are less relevant to a contract modification. Also in example 2 the application of the indicators in paragraph 13 is unclear.

Question 4

The boards propose that if the amount of consideration is variable, an entity should recognise revenue from satisfying a performance obligation only if the transaction price can be reasonably estimated. Paragraph 38 proposes criteria that an entity should meet to be able to reasonably estimate the transaction price.

Do you agree that an entity should recognise revenue on the basis of estimated transaction price? If so, do you agree with the proposed criteria in paragraph 38? If not, what approach do you suggest for recognising revenue when the transaction price is variable and why?

We agree that an entity should recognise revenue on the basis of estimated transaction price when consideration is variable. However, we noted that while paragraph 38(a) looks at both the experience of the entity and other entities, the literal reading of paragraph 38(b) can imply that the experience relevant would be solely the entity's experience.

Question 8

Paragraph 57 proposes that if costs incurred in fulfilling a contract do not give rise to a asset eligible for recognition in accordance with other standards (for example, IAS 2 or ASC Topic 330; IAS 16 or ASC Topic 360; and IAS 38 or ASC Topic 985 on software), an entity should recognise an asset only if those costs meet specified criteria.

Do you think that the proposed requirements on accounting for the costs of fulfilling a contract are operational and sufficient? If not, why?

We believe the proposed requirements are operational, but result in an economic distortion. Many types of entities, namely in: the communication, gas, construction and other industries, incur significant direct costs during the process of obtaining sales contracts (i.e., customers). Further, many entities pay such costs in the form of sales commissions. The economic rational for entities to carry the cost related to such commissions is due to the overall cash flow expected to be produced from the contract and/or customer. Under the proposed guidance, while revenue might be deferred till fulfilling related performance obligation, the entity must expense those customer acquisition costs in its statement of operation. We believe that a principle of capitalization of such cost should be incorporated into the ED so as to accurately reflect the entity's business and financial position as well as results reported.

Question 15

The boards propose that an entity should distinguish between the following types of product warranties:

(a) a warranty that provides a customer with a coverage for latent defects in the product. This does not give raise to a performance obligation but requires an evaluation of whether the entity has satisfied its performance obligation to transfer the product specified in the contract.

(b) a warranty that provides a customer with a coverage for faults that arise after the product is transferred to the customer. This gives rise to a performance obligation in addition to the performance obligation to transfer the product specified in the contract.

Do you agree with the proposed distinction between the types of product warranties? Do you agree with the proposed accounting for each type of product warranty? If not, how do you think an entity should account for product warranties and why?

While we understand the underlying concept of separation between the two types of warranties, we are concerned with its related application.

Specifically, the practicability of separating faults that are discovered after products were transferred into those that were in existence at the date of transfer (i.e., latent) and those that arose after transfer could be challenging.

While faults could arise after products were transferred, it is unclear if such are latent defects or not and whether caused by improper selection of materials or production processes - An entity may argue that the selection of unsuitable materials or production method also falls within the latent defect category. Said differently, one may argue that the fact that an entity has manufactured a product using improper materials and/or selected inappropriate production process is also a latent defect (i.e. while the product was transferred perfectly working it has inherent faults built into it that would later surface).

Moreover, we are concerned with the ability of entities to distinguish between the two and supporting the established separation in such a way that would be considered conclusive and unquestionable.

In addition, the proposed accounting for changes in estimates relating to product warranties on account of latent defects in products, would cause distortion of reported results at a time of a decrease in sales while changes in estimates are significant, possibly calling for negative revenue. We believe that such subsequent adjustment of previously recognised revenue is neither appropriate nor reflective of the transaction as the entity viewed it on the date it was contracted to carry it out. We believe that the initial, good faith, historically based estimate that was used by the entity was one of the main considerations in agreeing to the transacted price by the entity. Therefore, any subsequent change, except a correction of an error, should be viewed as an expense when it arises.

We appreciate the opportunity to provide our comments.

Sincerely,
Dov Sapir, CPA, Chairman
Israel Accounting Standards Board